

**CITY OF SAN DIEGO**

**MULTI-YEAR FINANCIAL FORECAST**

**FY 2005-06 to FY 2009-10**



**April 8, 2005**

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## EXECUTIVE SUMMARY

This Multi-Year Financial Forecast (MYFF) is intended to serve as a planning tool to bring a long-range perspective to the City's budget process. This forecast is not a prediction; it relies heavily on assumptions regarding economic events and policy decisions. Nor is the MYFF a budget; it does not make revenue or expenditure decisions. As is the case with most jurisdictions that prepare long-term financial forecasts, projections of out-year budget gaps, where forecasted expenditures exceed forecasted revenues, are to be expected; eliminating such gaps requires the weighing of priorities and the making of difficult decisions that are at the heart of the City's annual budget process. Nevertheless, by providing a forecast of revenues and expenditures over a five-year period, the MYFF will assist the City in identifying long-term trends, risks, and opportunities for developing strategies for achieving structural balance and eliminating deficits. Incorporation of this long-term perspective into the annual budget process will allow the City to make decisions today that will reduce the risk of budget gaps in the future.

The MYFF was prepared by two financial consultants, Public Resources Advisory Group and Kelling, Northcross & Nobriga, and the City Manager's Office. It consists of two parts: a financial model (the MYFF Model) and this report (the MYFF Report), which discusses inputs to and analyzes the results of the model. The model will allow the City to assess the likely course of financial events under a number of conditions and circumstances, and to perform "what if" analyses of potential decisions. Accordingly, the MYFF is not really a single forecast, but a series of forecasts based on alternative assumptions.

This report focuses on what has been established as a "Base Case" forecast (summarized on Schedule I of the MYFF Model), and an Alternative Scenario (Schedule I-B). The Base Case attempts to achieve long-term structural balance by incorporating various solutions to close the gap between revenues and expenditures.

	Budgeted FY 2004-05	Projected FY 2005-06	Projected FY 2006-07	Projected FY 2007-08	Projected FY 2008-09	Projected FY 2009-10
<b>Schedule I: Summary (Base Case)</b>						
General Purpose Revenues	\$ 923,917,598	\$ 965,263,885	\$ 1,028,183,189	\$ 1,077,176,953	\$ 1,126,205,730	\$ 1,176,030,185
General Purpose Expenditures	923,917,598	944,407,694	981,901,613	1,015,679,676	1,091,282,032	1,139,667,911
Retirement Liability Solutions	-	20,856,191	46,281,576	61,497,277	34,923,698	36,362,274
<b>Surplus/(Shortfall)</b>	<b>\$ -</b>	<b>\$ -</b>	<b>\$ -</b>	<b>\$ -</b>	<b>\$ -</b>	<b>\$ -</b>

The Alternative Scenario projects the operating results that would occur without budget balancing solutions; this scenario results in recurring budget deficits.

	Budgeted FY 2004-05	Projected FY 2005-06	Projected FY 2006-07	Projected FY 2007-08	Projected FY 2008-09	Projected FY 2009-10
<b>Schedule I-B (Alternative Scenario)</b>						
General Purpose Revenues	\$ 923,917,598	\$ 965,263,885	\$ 1,028,183,189	\$ 1,077,176,953	\$ 1,126,205,730	\$ 1,176,030,185
General Purpose Expenditures	923,917,598	1,013,489,894	1,077,601,564	1,119,868,023	1,211,640,613	1,273,399,783
Retirement Liability Solutions	-	-	-	-	-	-
<b>Surplus/(Shortfall)</b>	<b>\$ -</b>	<b>\$ (48,226,009)</b>	<b>\$ (49,418,375)</b>	<b>\$ (42,691,070)</b>	<b>\$ (85,434,883)</b>	<b>\$ (97,369,598)</b>

Both these scenarios are built on a reasonable forecast of revenues under the City's current revenue structure, and differ as to their expenditure assumptions. These two alternatives

represent only an initial attempt to forecast alternative financial futures. Additional scenarios should be analyzed on an ongoing basis as alternative proposals for achieving long-term structural balance are being considered. The key drivers of the forecast include:

- *General Fund:* The MYFF focuses on the City's General Fund, which accounts for all revenues that are not otherwise restricted. The General Fund finances most of the City's operations, including such core services as police, fire-rescue, and parks. Four special revenue funds are also included in the forecast, because they are funded with revenues that in many communities would be considered General Fund revenues: the Transient Occupancy Tax Fund, the Environmental Growth Fund, the Police Decentralization Fund, and the Fire and Lifeguard Facilities Fund. The City may expand this analysis to include other City funds in the future.
- *Revenue growth:* Many of the City's revenues will grow to reflect general inflation, while others will respond to more specific economic factors. In some cases, the amount of General Fund revenue will also reflect the allocation of resources between that fund and special revenue funds. Major revenue assumptions are outlined in Section III of the MYFF Report, and forecasted on Schedule II of the MYFF Model.
- *Salary growth:* Direct salaries and wages represent more than one-half of the General Fund budget. Total compensation, including retirement and benefits (which are based on salaries), represents about 78% of FY 2005 General Fund budgeted expenditures. Therefore, increases in salary expenditures are a major driver of the forecast. The Base Case scenario assumes a 3.2% decrease in salaries for FY 2006, no salary increases for FY 2007, and 2% increases thereafter. The Alternative Scenario assumes 3% increases throughout.
- *Retirement costs:* Projections of significant increases in the City's contributions to the San Diego City Employees Retirement System (SDCERS) and other retirement costs highlight the need for a planning tool such as the MYFF. The MYFF incorporates projections based on the June 30, 2004 actuarial valuation, as well as a number of other assumptions. These projections include changes in actuarial assumptions introduced by the recent passage of Proposition G, which will accelerate the amortization of unfunded actuarial accrued liabilities beginning in FY 2009, resulting in significant increases in funding requirements. While the City may issue pension obligation bonds in the future to restructure its pension contributions, the MYFF assumes that unfunded actuarial accrued liabilities will be amortized through annual contributions to SDCERS. To the extent a portion of that liability is funded with proceeds of pension obligation bonds (POBs), the debt service would replace a portion of that retirement contribution.
- *Flexible Benefits and other Fringe Benefit costs:* Flexible Benefits include the cost of providing employee health care and other benefits as part of the flexible benefit program. Even though health care costs have grown rapidly in recent years, the MYFF Base Case assumes that there will be no increased General Fund expenditures in this area for FY 2006 and FY 2007. It is therefore assumed that all flexible benefit cost increases will be paid by the employee. The category of other Fringe Benefits includes general employee

benefits such as workers compensation and unemployment insurance, which is projected to increase by inflation and will be paid by the City.

- *Committed expenditures:* The forecasts are based on the maintenance of existing staffing, after proposed FY 2006 reductions, with the addition of only “committed” additional expenditures. These consist primarily of salary step adjustments required by employee Memorandum of Understandings (MOUs) and salary ordinances and additional staffing for new facilities. Staffing for all new facilities except Fire-Rescue is deferred for FY 2006, and only staffing for new public safety facilities is assumed for FY 2007 and beyond; the funding of other new facilities such as recreation and parks and libraries will need to be identified for future years. This category of expenditure growth also includes inflationary increases to various expense items, including supplies and services, energy and utilities, and information technology.
- *Maintenance of General Fund Unappropriated reserves:* The model assumes that the City will continue to work towards the Council’s policy goal of reaching a General Fund unappropriated reserve equal to 5% of General Fund revenues. Pursuing the 5% goal is also reflected in the Alternative Scenario, where budget deficits are projected.
- *Budget balancing solutions:* The Base Case is built on the FY 2005 budget, but assumes a 3.2 % salary reduction in FY 2006, a salary freeze in FY 2007 and reductions in expenditures from position elimination and other cuts. Some of the specific solutions that should be considered are discussed in Section VI of the MYFF Report (Recovery Program). Development of actual solutions will require the input of elected officials, labor, the public, as well as City staff.
- *Unfunded needs:* A number of City needs have not been specifically addressed in the MYFF, including the Police Communications Plan, new park and library facilities, and various other unfunded capital and operating needs. These are summarized later in Section V.
- *Use of labor concessions:* The Base Case shows that labor concessions will be necessary to prepare for the significant rise in pension costs in the future. The MYFF assumes that any such labor concessions will be used to help reduce unfunded pension liabilities.

The “bottom line” results of the MYFF are expressed as an operating surplus or shortfall. Of course, by law, the City’s actual budget must be balanced, and therefore any deficit would be eliminated as part of the budgeting process. As noted above, the purpose of including a “deficit” or “budget gap” in a forecast is to reveal structural imbalance that must be eliminated.

# I. INTRODUCTION

This Multi-Year Financial Forecast (MYFF) is intended to serve as a planning tool to bring a long-range perspective to the City's budget process. The MYFF consists of two primary documents: the MYFF Model, which provides the analytic tool for undertaking the forecast and its analysis, and this MYFF Report, designed to communicate the key assumptions and conclusions of the analysis. In addition, there is a 92 page Appendix to the Model, which contains additional information on the costs of new facilities and various unfunded departmental requirements. Due to the size of the Appendix it is available online at <http://www.sandiego.gov/budget>.

By providing a forecast of revenues and expenditures over a five-year period, and incorporating a variety of core assumptions, the MYFF will assist the City in annually assessing its ability to meet the following key goals:

- Provide important City services after adjusting for inflation;
- Modify and make necessary changes to the pension system structure, including reducing unfunded actuarial accrued liabilities (UAAL);
- Meet future commitments, including staffing new public safety facilities; adhering to contractual commitments; and funding certain capital improvement program needs and mandated programs; and
- Achieve long-term goals relating to the City's overall financial health, including the maintenance of targeted levels of reserves and not exceeding specified debt service levels.

It will be clear upon reviewing the MYFF that the first goal—providing important City services—will be extremely challenging, due to growing financial pressures. The MYFF forecasts that revenue enhancements and/or expenditure cuts will be necessary to maintain a balanced budget.

Beyond maintaining key City services, the City has many unmet needs. While these potential expenditures are not currently incorporated within the MYFF, long-range planning will help the City assess its opportunities for funding at least some of these needs.

The Government Finance Officers Association (GFOA) recognizes the importance of combining the forecasting of revenues and the forecasting of expenditures into a single financial forecast. The GFOA also recommends that each government have a financial planning process to assess the long-term financial implications of current and proposed policies, programs, and assumptions and to develop appropriate strategies to achieve its goals. The GFOA recommends that governments at all levels forecast major revenues and expenditures; that such forecasts should extend at least three to five years beyond the budget period; and be regularly monitored and periodically updated. The MYFF is consistent with these GFOA recommended best practices.

## **II. FRAMEWORK OF THE FORECAST**

The primary focus of the MYFF is the City's General Fund. The General Fund is the City's main operating fund, used to pay for such basic municipal services as police, fire-rescue, refuse collection, recreation and parks and libraries. Most of the City's tax revenues are deposited into the General Fund, as well as revenues from licenses, permits and fines. Most of the City's other funds are not included in this first version of the MYFF. Over time, it is anticipated that the scope of the forecast will be expanded to include certain special revenue, enterprise and capital funds.

This initial version of the MYFF forecasts General Fund operations for five years, from FY 2005-06 through FY 2009-10. General Fund revenues are detailed in Schedule II of the MYFF model, and General Fund expenditures are detailed in Schedule III. The revenue and expenditure portions of the MYFF have been developed independently, based on a variety of known and assumed factors that drive each revenue and expenditure line item.

Since the City budgets a portion of its general-purpose revenues in various Special Revenue Funds to pay debt service on outstanding lease obligations and other targeted expenditures, the current MYFF is expanded beyond the General Fund to incorporate a few other general-purpose funds. These revenues include Sales Tax, Safety Sales Tax, Transient Occupancy Tax (TOT), and Franchise Fees. A portion of these revenues is deposited in the TOT, Environmental Growth, Police Decentralization and other special funds. The General and Special Fund allocation of these revenues is detailed in Schedule IV of the MYFF Model. Schedule V of the model details the allocation of TOT and Sales Tax revenues to and expenditures from the Special Promotional Program. More information on these funds appears in Section III of this MYFF Report.

The MYFF includes an analysis of the City's General Fund-secured and general obligation debt, calculating key ratios used by the rating agencies and investment community to evaluate the City's creditworthiness. In comparing debt service to revenues and expenditures, the Special Funds outlined above are included with the General Fund to determine "General Purpose Revenues", which serves as the denominator of the ratios. The City's General Fund-related debt structure is presented in Schedules VI and VII of the MYFF Model. Schedule VIII of the model performs the analysis of debt and other financial indicators.

The model also is designed to reflect the City Council's goal of achieving General Fund reserves equal to 5% of revenues by 2014. It is also assumed that the City will comply with its Library, Mission Bay and Parking Meter ordinances, beginning in FY 2006-07. These funding requirements are assumed to be waived for FY 2005-06.

Schedule I—Base Case of the MYFF model summarizes the results, incorporating General Fund revenues and expenditures with the activities of the four general-purpose Special Revenue Funds. The "bottom line" result is reported as a "Net Surplus/ (Shortfall)" (with negative results, representing operating deficits, presented in parentheses). It is important to reiterate that a negative result in a forecast is not a projection that the City will be operating at a deficit. Under the California Constitution and the City's own Charter, the budget must be in balance every year. If needed, the City may expend more than it receives in revenues during any given year by drawing down on its prior year operating surpluses or savings, but the City cannot operate with



ongoing deficits. While the MYFF may “forecast” deficits under a number of scenarios, the City can be expected to address those budget gaps as they occur as part of its annual budgeting process, eliminating any budget deficit through reduced expenditures or increased revenues. The MYFF is a new important tool in achieving such budget balance. It will help the City to analyze the long-term impact of decisions made today, aid in minimizing decisions that will create long-term financial pressures, and encourage decisions that restore long-term structural balance.

### **III. REVENUE FORECAST**

The Revenue Forecast combines an analysis of the general economic factors driving the City’s revenue base, and the specific revenue sources available to the City. While San Diego’s economy is increasingly diverse and vital, the City’s revenue structure is relatively limited for a large city. The revenue structure reflects various historical decisions to limit exactions. For example, the City does not levy a utility user’s tax or refuse collection fee, has low business taxes, and has kept local taxes such as real estate transfer taxes low, bucking the trend of other large cities in the State. Even the City’s share of the 1% property tax is relatively low, as the low tax rates levied in the 1970’s became permanently institutionalized in the State law implementing 1978’s Proposition 13.

The City’s revenues are increasingly affected by decisions made by the State regarding the allocation of local revenue. Three of the City’s largest historical General Fund revenues—property tax, sales tax, and motor vehicle license fees—are all subject to State legislative actions, and have been impacted by recent and past State budget decisions.

#### ***1. Economic Assumptions***

This MYFF reflects assumptions about the future economic environment. These assumptions were developed after reviewing the projections of State and national economic forecasts, including the UCLA Anderson Business Forecast and DRI/Global Insight.

Because of San Diego’s well-diversified economy and strength in research driven technology industries, local economic growth is anticipated to continue to outpace the rest of the State and nation. Among California’s most daunting challenges is the State budget, with a structural imbalance remaining from the State spending more than its income over several years. The imbalance is “funded” by State borrowing of \$15 billion through the sale of bonds and from revenue taken from cities, counties and school districts across California. The MYFF assumes that the State will maintain local government revenues as agreed to as part of the 2004-05 State budget deliberations, that no new revenue shifts will be implemented in future years, and that certain diverted property taxes will be restored beginning in FY 2007.

The revenue forecast takes into consideration the following specific economic assumptions:

- Real Gross Domestic Product is expected to grow within a range from 3.1 to 3.6% over the forecast period.
- Interest rates are expected to steadily rise over the forecast period. The Federal funds rate has risen from 1.33% in 2004 and is anticipated to reach 5.1% by 2010. Mortgage rates

are also expected to rise over the period, although not quite as dramatically as the Fed rate, from 5.9% in 2004, to 7.9% in 2010.

- Historically low national inflation rates should be steady at around 2.6%. Although remaining above national levels, local inflation is anticipated to moderate from 3.7% in 2004 to between 3.3 and 3.5% through 2010.
- The City's population growth levels is anticipated to moderate from the recent 1.8% gain in 2003 to just less than 1.0% annually over the forecast period. Total population is expected to grow from 1,294,000 residents in 2004 to 1,370,000 residents in 2010.
- County unemployment should remain below State and national unemployment rates, averaging between 4.4% and 4.7% over the forecast period.

This set of economic assumptions produces overall revenue growth averaging about 4% a year over the forecast period.

## **2. *General Fund Revenues***

The following summarizes the City's major General Fund revenue sources as they are shown in the MYFF model. In comparing year-to-year changes, it is important to note that General Fund revenues from many of these sources will reflect both economic activity and the allocation of these revenues between the General Fund and various special funds.

### **A. *Property Tax***

Property Tax remains the single largest General Fund revenue. Because of the methodology by which property tax is allocated among overlapping taxing jurisdictions, the City of San Diego currently receives only about 17% of the 1% tax rate levied under Proposition 13. The basis for allocation under State law is the average tax rate levied by the taxing agency for the three years before Proposition 13 was adopted (referred to as "the AB 8 formula"). Because of its low tax rate at the time of the passage of Proposition 13, San Diego receives a relatively smaller allocation of the 1% than many other cities in the State.

Property tax revenue has experienced strong growth over the past five fiscal years at 8.7% (6.7% for the past ten years), and this strong growth is projected to continue, in part due to a continuing strong real estate market. The major risk to Property Tax revenues in the next few years is inflation. A sudden increase in inflation will cause mortgage rates to rise significantly, and the housing market to slow down quickly. Property tax growth can be expected even if prices are stable, as accumulated appreciation is recognized when property is reassessed at the time of sale. If the real estate market cools off, however, the reduced number of transactions will translate into slower growth in the tax base and a concurrent reduction in Property Transfer Tax.

Several features of the State budget affect the Property Tax forecast, as the State has taken advantage of its power under State law to reallocate this revenue to address a number of its own objectives.

- In FY 2005, the State of California enacted a complex shift, whereby revenue from state-collected Motor Vehicle License Fees (VLF) was exchanged for property tax. This revenue shift resulted from the elimination of the State's VLF backfill, which was paid to local governments directly from the State's General Fund. In order to hold local governments harmless, the State shifted property tax revenue from the Educational Revenue Augmentation Fund ("ERAF", a mechanism used to fund local schools with property taxes in order to reduce state funding requirements) to local governments in proportion to each jurisdiction's VLF backfill loss. In FY 2005, these actions resulted in approximately \$71 million being shifted from VLF to property tax for the City of San Diego.
- In addition, FY 2005 marked the first year of a two-year agreement in which local governments agreed to contribute revenue to the State in exchange for the Governor's support of Proposition 1A, a State constitutional amendment designed to protect local government revenues, which passed in the November 2004 election. For the City of San Diego, this two-year contribution amounts to a reduction in property tax revenues of approximately \$16.9 million in both FY 2005 and FY 2006. This revenue will be reduced from the property tax in lieu of VLF that is shifted from ERAF to local governments, as described above. The expiration of the agreement in FY 2007 results in a substantial increase in projected revenue from FY 2006, as the City will no longer make the \$16.9 million contribution. As a result, Property Tax is forecast to experience even higher growth in FY 2007.
- A third reallocation involving Property Tax is referred to as the "Triple Flip," and is discussed under Sales Tax, below.

## **B. Sales Tax**

A 7.75 cent Sales Tax is levied on each dollar of taxable sales within the City's boundaries. Of that amount, 0.50 cents is attributable to Proposition A Transnet, and the balance reflects the statewide levy. One-cent of the statewide levy historically has been allocated to the City under the State's Bradley-Burns law. About 67% of this amount has been allocated to the General Fund. In addition, a small additional amount of these funds are projected to be allocated toward the City's General Fund Unappropriated Reserve to maintain Council approved levels; these contributions are projected to represent less than 2% of Sales Tax revenues. The balance of Sales Tax revenues are allocated to the Transient Occupancy Tax Fund, the Street Division and the Police Decentralization Fund. A small fraction of Sales Tax revenues, representing a portion of the tax receipts generated from specific redevelopment projects areas, is allocated under development and owner participation agreements. The MYFF projects a similar allocation going forward (see Schedule IV of the MYFF Model: Special Funds - General Purpose Revenues and Operating Expenditures).

Sales Tax revenue is highly sensitive to economic conditions, and reflects the factors that drive taxable sales, including the levels of unemployment, consumer confidence, per-capita income, and business investment. Growth in this revenue has averaged 4.0% over the past five years, and 6.5% over the past ten years.

The sales tax projections also take into account the impact of the “triple-flip,” a complex revenue shift that resulted from the passage of Proposition 57 in the March 2004 elections. Proposition 57 authorized the State to issue up to \$15 billion in Economic Recovery Bonds to pay off the accumulated deficit in the State’s General Fund. To secure the bonds, the State has implemented a complex revenue shift known as the “triple-flip,” whereby local governments will shift ¼-cent of their one-cent Bradley-Burns Sales and Use Tax to the State in exchange for an equivalent amount of property tax, which will be shifted from the Educational Revenue Augmentation Fund. While the triple-flip is intended to hold local government harmless, the intricate mechanics of this shift will result in minor fluctuations in sales tax revenue from year to year.

In all forecast years, the property tax reimbursement from the triple-flip is included in the Sales Tax projection. This is done for two principal reasons. First, the year-over-year growth in the reimbursement amount will be equivalent to the growth in taxable sales, not the growth in assessed valuation. As such, it is considered a subset of Sales Tax for forecasting purposes, not a subset of Property Tax. Secondly, once the Economic Recovery Bonds are paid off, cities will no longer receive the property tax reimbursement, but will instead regain the ¼-cent sales tax that was diverted to the State by the triple-flip. In these two ways, the property tax reimbursement from the triple-flip is markedly different from the VLF-property tax swap, as described in the previous section. In the case of the latter, the VLF-property tax swap marks a permanent shift of revenues from VLF to property tax. Beginning in FY 2006, this shift will no longer be considered a revenue swap, but rather a permanent increase in property tax revenue, with year-over-year growth being based on the growth in assessed valuation.

### **C. Safety Sales Tax**

Safety Sales Tax revenue is derived from Prop 172, the Local Public Safety Protection and Improvement Act of 1993, which was approved by California voters on November 2, 1993. Monies received as the City’s allocation from the State for this half-cent Sales Tax must be utilized solely for public safety services. A portion of these revenues are allocated to the Fire and Lifeguard Facilities Fund to pay for lease payments and project/debt management costs related to the lease revenue bonds issued for the construction/capital improvement of fire and lifeguard stations throughout the City and the acquisition of land for future construction of fire and/or lifeguard facilities. The Fire and Lifeguard Facilities Fund was established in June 2002. The balance of the Safety Sales Tax funds is used to augment existing General Fund expenditures for public safety purposes such as purchases of equipment, supplies, and to continue funding salary adjustments that have occurred since the inception of the Safety Sales Tax.

### **D. Transient Occupancy Tax (TOT)**

Commonly known as the hotel tax or room tax, San Diego’s TOT is levied at ten and one-half cents per dollar of the daily room price. Currently, an equivalent of five cents of the TOT, approximately 48%, is allocated to Special Promotional Programs for the promotion of tourism and other purposes designated by City Council policy, and deposited in the Transient Occupancy Tax Fund. The remaining five and one-half cents, approximately 52%, is allocated directly to the General Fund for general government purposes (see Schedule IV of the MYFF Model: Special Funds - General Purpose Revenues and Operating Expenditures, and Schedule V: TOT Fund/Special Promotional Program Allocations). Growth in this revenue has averaged 3.1% over

the past five years, and 7.5% over the past ten years. Two recent efforts to increase this tax have failed to win voter approval.

### **E. Property Transfer Tax**

Consistent with State law, the County charges \$1.10 per \$1,000 of sale price when any real property is transferred. The City of San Diego charges \$0.55 per \$1,000, which is credited against the County's charge, so that the City and the County both receive \$0.55 per \$1,000. This revenue source has outperformed inflation in the past (averaging 18.9% in annual growth for the past five years, and 19.0% in annual growth over the past ten years), particularly soaring with the recent real estate boom. The FY 2005 Annual Budget originally projected a 6% growth in Property Transfer Tax revenue; it now appears it will be closer to 28%. The MYFF projects an additional 10% growth in FY 2006. Given the potential volatility of this revenue, a more modest 8% growth rate is projected thereafter.

It is interesting to note that this revenue has been growing much faster than property tax itself. One of the reasons for this is that growth in assessed values (which derives in large measure from the transfer of property) only results in growth in General Fund property tax when it occurs outside of a redevelopment project area. Similar growth within the project areas has resulted in tremendous growth in tax increment, which is outside the scope of this study. The General Fund receives property transfer taxes for all sales that occur within a redevelopment project area.

As mentioned above, a significant slowing of real estate sales will cause this revenue source to slow as well.

### **F. Licenses and Permits**

The Licenses and Permits category reflects revenue generated to recover costs associated with performing regulatory functions. Major budgeted revenues in this category include general business license taxes, rental unit taxes, parking meter collections, and the refuse collection business license tax.

### **G. Fines, Forfeitures, and Penalties**

Fines, Forfeitures, and Penalties include revenue generated from monetary sanctions associated with the violation of a law or regulation such as California Vehicle Code violations, City parking and ordinance violations, and litigation awards. Parking violations represent about half of this revenue.

### **H. Revenue from Money and Property**

This category includes revenue from franchises to use the City's rights-of-way; rents and concessions from Mission Bay and other City properties; and interest earnings.

Franchise Fees are set through franchise agreements that are negotiated with individual utility companies. San Diego Gas & Electric (SDG&E), the single largest generator of Franchise Fee revenue, is charged 3% of gross sales from gas and electricity within the City. Three-fourths of

total SDG&E franchise revenue is allocated to the General Fund, while one-fourth is required by the City Charter to be allocated to the Environmental Growth Fund.

Franchise revenue from SDG&E remains unstable. Late in calendar year 2000, an unusual spike in natural gas prices sent utility bills soaring, increasing Franchise Fee revenue by nearly 45%. However, the unusually high natural gas prices did not last, and in FY 2003, SDG&E Franchise Fee revenue fell almost 33%. SDG&E Franchise Fee revenues were up another 21% in FY 2004. Over the past five years, the average growth in this revenue source has been almost 10% a year. The City has set a conservative estimate, forecasting 11.8% growth for FY 2006, and 7.0% thereafter as part of the MYFF.

The Rents and Concessions category includes General Fund revenue generated from Mission Bay Park (the largest component), Balboa Park, Torrey Pines Golf Course and lease agreements on City Pueblo lands. The Mission Bay Ordinance requires that one-half of all revenue from Mission Bay rents and concessions in excess of \$20 million be allocated to the Mission Bay Improvement Fund and the Regional Park Improvement Fund. (See the discussion of special funding ordinances in Section V-3, below.) This requirement was waived in FY 2005. The MYFF assumes it will be waived in FY 2006, with compliance restored beginning in FY 2007.

## **I. Revenue from Other Agencies**

Historically, the largest revenue in this category was the Vehicle License Fee, which was levied by the State at 2% of depreciated vehicle value and replaced local property taxes on vehicles. Since 1999, the State has been reducing these fees and backfilling the lost revenues to the cities and counties out of its General Fund. With the FY 2004-05 State budget, the VLF has been permanently set at 0.65% of depreciated vehicle value, and backfill revenues have been replaced with an equal amount of property taxes shifted from schools and community colleges. (See the discussion under Property Taxes, above.) Accordingly, this revenue has been reduced significantly beginning with the FY 2005 Budget. The City was scheduled to receive approximately \$21.6 million in deferred VLF revenues from the State. The City has sold this receivable to a statewide financing pool, and is applying the proceeds to decrease outstanding debt. (See “New On-Going Revenues Included in MYFF,” below.)

This category also accounts for most of the revenues from the tobacco settlement and State grants. Grant receipts are forecasted to be reduced from \$9.2 million in FY 2005 to \$2.1 million in FY 2007, given the uncertainty in the State’s financial condition.

## **J. Charges for Current Services**

This category includes revenue generated by General Fund departments from services provided to other City funds, including the water and wastewater funds. In addition, a number of departmental charges for public services are included in this category, most significantly by the Fire-Rescue and Police departments.

## **K. Transfers from Other Funds**

The City regularly transfers funds from various special revenue funds to the General Fund for various purposes. The largest source of such transfers is the residual available in the Transient Occupancy Tax Fund after other allocations. Also included in this category are a variety of one-time revenues.

## **L. New Revenues - One Time**

The MYFF Model divides the revenue analysis on Schedule II between two Scenarios. The first includes no new revenues, and the second shows the impact of several new revenues. Scenario 2 is used for both the Base Case and the Alternative Scenario described under the discussion of the “Expenditure Forecast,” below.

The revenue category of new one-time revenues has been used to capture expenditure reductions in various special funds, and the transfer of the resulting savings to the General Fund. These additional transfers reflect certain assumptions made in the MYFF, specifically, the one-year delay of staffing for new facilities and waiver of the Library and Mission Bay ordinances further described below. For FY 2007, the line item for “Future Miscellaneous Revenues” accounts for yet-to-be identified one-time revenues. San Diego, like other big cities, can expect a certain level of such revenues in any given fiscal year. Based on historical receipts, an average of \$11 million a year in unidentified one-time revenues is a conservative estimate.

## **M. New On-Going Revenues Included in MYFF**

The MYFF identifies one new recurring revenue, which is itself generated by the application of a one-time revenue. The MYFF assumes annual savings of \$6.6 million in General Fund debt service due to the redemption of Open Space General Obligation Bonds. The early redemption of these bonds is funded from the \$20.4 million the City received from the sale of its VLF receivable in February 2005 (see Revenue from Other Agencies, above), together with \$4.4 million available in the Environmental Growth Fund.

This new revenue is partly offset by the elimination of one revenue source, the City’s Right-of-Way Fee. The City currently transfers about \$2.3 million from its water and sewer enterprises as fees for the use of public rights-of-way. The MYFF assumes these transfers are eliminated in FY 2006.

## **3. *Other General Purpose Revenues***

For a variety of historical reasons, the City maintains several other funds that should be considered in any analysis of general City resources: the Transient Occupancy Tax Fund, the Police Decentralization Fund, the Environmental Growth Fund, and the Fire and Lifeguard Facilities Fund. While these funds are accounted for as “Special Revenue Funds” (funds created to account for revenues that are dedicated to specific purposes), they are heavily integrated with the General Fund. They are also the funds responsible for paying all of the City’s current General Fund debt service.

These funds have been incorporated within the MYFF as part of the City's general-purpose revenue base, particularly when calculating budget-based debt ratios. When calculating total general-purpose revenues, the MYFF nets out the amount transferred from these funds to the General Fund; this net amount of revenues is added to General Fund revenues to determine total general-purpose revenues.

These funds are detailed in Schedules IV and V of the MYFF Model and summarized below.

#### **A. Transient Occupancy Tax (TOT) Fund**

This fund receives a portion of the City's TOT (5 cents of the 10.5 cents, with the balance going directly to the General Fund), and an allocation from the General Fund equivalent to 3.5 cents of the 10.5 cent TOT. The Fund finances the Special Promotional Programs Budget, and makes transfers to several other special revenue funds used to pay debt service for the Convention Center, Balboa Park and Mission Bay improvements, PETCO Park, Trolley Expansion, and other miscellaneous lease revenue financings. A portion of this Fund is transferred back to the General Fund; the amount of this transfer increased in FY 2005 as a result of budgetary reductions to benefiting organizations.

#### **B. Environmental Growth Fund**

This fund receives 25% of the franchise fee paid by San Diego Gas & Electric, as required by the City Charter. Two-thirds of this amount has been used to pay debt service on the City's Open Space Facilities general obligation bonds, in lieu of the City's levying additional property taxes for that purpose as is more typical of general obligation bonds. The remaining one-third is used for the purpose of preserving and enhancing the environment, including open space and regional park maintenance and to provide matching funds for acquiring open space in cooperation with other private or governmental entities.

#### **C. Police Decentralization Fund**

A portion of the City's share of the 1% sales tax revenue is allocated to this fund to pay debt service on Series 1994 Police CIP Refunding Lease Revenue Bonds and to pay for jail services in accordance with a contract between the City and the County of San Diego. While the outstanding debt on the lease revenue bonds will be retired in FY 2006, the Police Decentralization Fund will continue to receive a sales tax allocation in order to fund the ongoing jail-related services.

#### **D. Fire and Lifeguard Facilities Fund**

A portion of the City's Safety Sales Tax revenues, funded out of a statewide voter-approved half-cent sales tax, is allocated to this fund to pay debt service on lease revenue bonds issued to finance Fire and Lifeguard facilities. The balance of the tax is allocated directly to public safety services within the General Fund.



## IV. EXPENDITURE FORECAST

The primary costs to any city are its employees, who are responsible for delivering police, fire-rescue and other municipal services. Direct salaries and wages represent 54% of San Diego's FY 2005 General Fund budget. Total compensation, including retirement and other benefits, represent 78% of FY 2005 General Fund budgeted expenditures.

The MYFF is built upon the FY 2005 budget and expectations for the proposed budget for FY 2006, which is currently being prepared. Two basic scenarios have been forecasted.

The first expenditures scenario is a "Base Case," which incorporates various assumptions for balancing the budget in future years. This case assumes a 3.2% reduction in salaries for FY 2006, followed by no change in salaries for FY 2007, absorption of benefit cost increases by the employee for two years, and \$24.6 million in unspecified personnel and expense reductions in FY 2006 solutions. The subject of achieving long-term balance is further discussed in "Section VI: Recovery Program," below. The Base Case forecasts operating savings that can be utilized for pension solutions. The Base Case assumes that the City will begin preparing in FY 2006 for sharply increasing retirement contributions, first in FY 2006 with another sharp increase in FY 2009. The MYFF assumes that any operating savings as a result of labor concessions would be applied towards addressing the unfunded liabilities of the retirement system in order to restore long-term stability.

The second expenditure scenario, referred to as the "Alternative Scenario" and appearing as Schedule I-B of the MYFF Model, represents a status quo forecast. Salaries are projected to increase in all years, and none of the recommended budget solutions are implemented with the exception of the waiver of special funding ordinances. This scenario produces significant budget deficits in every year, ranging from \$42 million to \$97 million (in FY 2010). Over the five years of the forecast, the mismatch in revenue and expenditures would produce a cumulative deficit of \$323 million. Because the City cannot operate with continuing deficits, the Base Case described above was developed to achieve relative balance. The tables below summarize the two expenditure forecast scenarios.

### GENERAL PURPOSE REVENUES AND EXPENDITURES

	Budgeted FY 2004-05	Projected FY 2005-06	Projected FY 2006-07	Projected FY 2007-08	Projected FY 2008-09	Projected FY 2009-10
<b>Schedule I: Summary (Base Case)</b>						
General Purpose Revenues	\$ 923,917,598	\$ 965,263,885	\$ 1,028,183,189	\$ 1,077,176,953	\$ 1,126,205,730	\$ 1,176,030,185
General Purpose Expenditures	923,917,598	944,407,694	981,901,613	1,015,679,677	1,091,282,032	1,139,667,910
Retirement Liability Solutions	-	20,856,191	46,281,576	61,497,277	34,923,698	36,362,274
<b>Total General Purpose Surplus/(Shortfall)</b>	<b>\$ -</b>	<b>\$ -</b>	<b>\$ -</b>	<b>\$ -</b>	<b>\$ -</b>	<b>\$ -</b>
<b>Schedule I-B (Alternative Expenditure Scenario)</b>						
General Purpose Revenues	\$ 923,917,598	\$ 965,263,885	\$ 1,028,183,189	\$ 1,077,176,953	\$ 1,126,205,730	\$ 1,176,030,185
General Purpose Expenditures	923,917,598	1,013,489,894	1,077,601,564	1,119,868,023	1,211,640,613	1,273,399,783
Retirement Liability Solutions	-	-	-	-	-	-
<b>Total General Purpose Surplus/(Shortfall)</b>	<b>\$ -</b>	<b>\$ (48,226,009)</b>	<b>\$ (49,418,375)</b>	<b>\$ (42,691,070)</b>	<b>\$ (85,434,883)</b>	<b>\$ (97,369,598)</b>

**City of San Diego**  
**Multi-Year Financial Forecast**  
**Summary of Major General Fund Expenditures**

	<b>Base Case</b>			<b>Alternative Scenario</b>	
	(with Solutions)			(No Solutions, 3% Salary Growth)	
	Budgeted FY 2004-05	Growth from Prior Year FY 2005-06	Average Annual Growth Rate FY's 2007-10	Growth from Prior Year FY 2005-06	Average Annual Growth Rate FY's 2007-10
Salaries & Wages	\$442,495,859	1.2%	1.4%	7.7%	3.7%
Retirement					
Retirement	86,685,110	38.4	11.8	47.1	14.1
Retirement Offset	24,367,160	0.5	0.6	6.8	3.7
Retiree Health	0 <sup>(1)</sup>	n/a	12.0	n/a	12.0
Subtotal Retirement	111,052,270	39.4	10.1	47.6	12.4
Fringe (w/o Retirement or Flex)	46,312,393	-2.9	7.0	3.9	9.3
Flexible Benefits	37,518,763	-2.2	6.6	5.0	8.3
Supplies & Services	125,941,888	-0.3	2.4	-0.3	3.4
Information Technology	19,554,311	6.0	3.0	6.0	3.0
Energy/Utilities	17,751,958	-0.3	3.0	-0.3	3.0
Equipment Outlay	16,805,547	-20.2	3.0	-20.2	3.0
	\$817,432,989	5.4%	3.8%	10.7%	5.8%

<sup>(1)</sup> Mid-year Budget adjustment was made to fund \$4.1 M toward General fund portion of the FY 2005 retiree health expenditure.

## ***1. Salaries***

The basic forecast of personnel costs is based on the FY 2005 General Fund budget and the continuation of already approved positions. An annual salary adjustment is added to account for the step increases provided to employees over time and the effect of turnover. In the initial years, the adjustment represents savings, reflecting turnover and subsequent new hiring at lower steps, combined with the fact that a large percentage of employees are now at the top salary step (Step E).

Because all of the City's labor agreements will expire on June 30, 2005, future salary growth is the subject of current negotiations through the meet-and-confer process. The Base Case assumes a 3.2% salary reduction in FY 2006, no change in FY 2007, followed by annual increases of 2%. The Alternative Scenario assumes 3% annual increases begin in FY 2005-06.

## ***2. Pension System Contributions***

This represents one of the fastest growing expenditure areas. Rapid growth in the UAAL within San Diego City Employees' Retirement System (SDCERS) requires that the amount of resources allocated to amortize the UAAL also grow significantly. This growth in UAAL represents a

combination of investment losses, increased benefits, past deferral of funding, and changes in actuarial assumptions. The forecast assumes that the City will make its full payment obligations consistent with the provision of the Gleason Settlement and Proposition G, as described below. The MYFF does not incorporate any savings from the issuance of pension obligation bonds, although a plan to refund a portion of the UAAL with bonds is currently under development.

Several of the key factors driving the City's contribution to its retirement system and its impact on the MYFF are described below.

### **A. Gleason Settlement**

Commencing in July 1996, the City was making annual contributions to SDCERS in accordance with a funding method that permitted contributions to be made by specified rates that were below the actuarially required rates of contribution. In response to litigation alleging that the City violated the City Charter and the Municipal Code by failing to contribute to SDCERS at rates determined by the SDCERS actuary, the City entered into the "Gleason Settlement" in July 2004. The settlement provides that the City will contribute a fixed amount of \$130 million for City-wide contributions in FY 2005. Commencing with the June 30, 2004 Annual Actuarial Valuation, the UAAL amortization period will be reset to a new 30-year fixed amortization period; for Fiscal Years 2006, 2007 and 2008, the City's contribution will be based on the actuarially determined funding level with the new 30-year fixed amortization period commencing with FY 2005.

### **B. Proposition G**

Proposition G, a Charter amendment approved by San Diego voters on November 2, 2004, requires that the amortization period for UAAL be shortened to no longer than 15 years beginning with FY 2009. Shortening the amortization period from 26 years (the remaining term under the 30-year amortization established by the Gleason Settlement) to 15 years will have the effect of increasing the annual cost to amortize the liability. The forecast projects General Fund contributions to the retirement system growing from an estimated \$160 million in FY 2008 to estimated \$204 million in FY 2009 and estimated \$223 million in FY 2010, largely as a result of the accelerated amortization. The MYFF assumes the more conservative application of the proposition, defining the amortization period as a fixed 15-year term (with the remaining term declining each year), as opposed to a rolling 15-year term, which results in a modest increase in funding requirements.

### **C. Pension Obligation Bonds (POBs)**

As one of the strategies for addressing SDCERS' high outstanding UAAL, the Pension Reform Committee recommended an infusion of up to \$600 million in assets into the pension system over Fiscal Years 2005-2007. The specific recommendation was to fund no less than \$200 million during FY 2005 through the issuance of POBs. Subsequent funding phases, bringing the total to \$600 million, were recommended through the issuance of additional POBs or some form of real estate secured transactions.

The MYFF does not currently reflect the use of POBs. To the extent a portion of the outstanding UAAL is funded with POBs, the debt service on the bonds would replace a portion of the City's total retirement contribution attributable to the amortization of the UAAL. The City would only issue such POBs if it projected that total expenditures for retirement funding would be reduced. In general, POBs are expected to reduce the present value cost of funding the system due to the fact the interest rate on the bonds would be lower than the actuarial interest rate used to determine the amortization of the UAAL through annual payments. The latter rate is based on expected returns on SDCERS' investment portfolio.

#### **D. MYFF Assumptions for Retirement System Contributions**

The MYFF incorporates the provisions of the Gleason settlement and, beginning with FY 2009, Proposition G amortization changes. Contribution rates are based on projections performed by the City's consultant on actuarial analyses, Towers Perrin, incorporating SDCERS actuarial valuation as of June 30, 2004 and future year projections also performed by the SDCERS actuary, with modified assumptions as to citywide payroll amounts. The actual rates in the future will vary among the various retirement groups, such as Safety Employees and General Employees, which are not proportionately distributed between the General Fund and other funds. The following table summarizes the projected employer contribution rates for retirement.

<b>Pension Contribution Rate City's Projections<sup>(1)</sup></b>	
<b>Fiscal Year<sup>(2)</sup></b>	<b>Contribution Rate</b>
2006	27.39
2007	26.50
2008	27.27
2009	35.29
2010	37.78

<sup>(1)</sup> 30-year fixed amortization for FY 05-08, 15 year *fixed/declining* thereafter.

<sup>(2)</sup> Fiscal Year 2006 is based on the 2004 Actuarial Valuation adopted by SDCERS. Fiscal Year 2007 and beyond are based on projections by the SDCERS actuary with modified citywide salary assumptions.

#### **E. Retiree Health Benefits**

The Municipal Code currently provides that in years when SDCERS earnings exceeded its actuarial target, that a portion of the City's employer contributions be deposited into a retiree's health care trust. Retiree health care benefits have historically been paid from the trust until funds were exhausted; subsequently, the City would pay directly from any source available. While this long-term practice was determined legal and was a common governmental practice, the Pension Reform Committee and the City Manager recommended that the practice cease. Starting FY 2005, retiree health care benefits are funded in a manner that does not reduce the assets of SDCERS.

The total retiree health cost for FY 2005 was budgeted at \$14.4 million. Of that amount, \$7.9 million was paid from the retiree health care trust fund. Of the remaining retiree health care

expenses (\$6.5 million), the General Fund's share was approximately \$4.1 million and Non-General Fund departments' portion was approximately \$2.4 million. The total retiree health cost for FY 2006 is currently estimated at approximately \$16.5 million on a cash basis. This entire amount will be funded on a cash basis by the City, with the General Fund departments contributing \$10.3 million and the Non-General Fund departments contributing \$6.2 million. Retiree health costs are assumed to be paid by the City on a cash basis throughout the forecast period.

## **F. Retirement Offset**

This line item of expenditure in the MYFF Model represents a portion of the employees' contribution that the City has agreed to pay under current labor agreements.

## **G. Partnering with Labor Organizations**

On June 30, 2005, labor agreements with all four labor organizations will expire, and negotiations are currently in progress. As discussed below in Section VI: Recovery Program, management has made a number of proposals that would lower the salary base of the City, increase employee contributions to the retirement system, and reduce retiree health expense. If agreed to, these measures would help reduce the growth in the UAAL and generate savings in the City's overall annual pension costs from lower normal cost contributions, relief on employee retiree offset, and reduced retiree medical costs.

## **H. Use of Any General Fund Savings**

As discussed above, under the Base Case scenario the General Fund could produce an operating savings in some years as a result of labor concessions. The MYFF assumes that any such savings would be used towards further reducing the retirement system's UAAL.

## **3. *Fringe Benefits***

This line item refers to costs associated with various employee-related costs, other than the Flexible Benefits Program. The primary components of this line item are workers compensation, Medicare, unemployment insurance, risk management, and compensated time off.

## **4. *Flexible Benefits***

This category includes the City's cafeteria benefits plan, of which the highest cost component is health insurance. The forecast assumes that expenditures in this area will be frozen for FY 2006 and FY 2007. This does not reflect an expectation that costs for these benefits will not rise, but that any such costs will be absorbed by employees in the form of higher employee contributions or reduced benefits. Beginning with FY 2008, it assumes that the City absorbs increases in costs, which are forecast to grow by 8.8%.

## ***5. Future Commitments Related to New Facilities***

The MYFF incorporates the cost impacts associated with the staffing of new public safety facilities, and, in some instances, increases resulting from state or federal mandates. A major budgetary challenge facing the City in recent years has been the long-term costs of staffing and maintaining public facilities constructed by non-City funds. Since these new facilities and their related operational costs are phased in over a period of time, their future fiscal impacts, including the capacity of forecasted revenues to support the increased costs, are highlighted by the MYFF. In order to achieve budget balance, the Base Case assumes that in FY 2006 funding for all new facilities except fire-rescue facilities will be absorbed by existing departmental operating budgets. Beginning in FY 2007, the costs of only new public safety facilities are included as new General Fund expenditures in the Base Case. The funding of other new facilities such as recreation and parks and libraries will need to be identified for future years.

## ***6. Supplies, Services, Information Technology and Energy/Utilities***

These line items capture most of the City's non-personnel expenses supported by the General Fund. The MYFF assumes that these expenditures will generally grow by inflation.

# **V. OTHER FINANCIAL AND SERVICE OBJECTIVES**

In addition to achieving a balanced budget that at least comes close to maintaining existing levels of service, the City has identified other financial and service objectives that are critical to the City's continuing goals of providing critical City services, maintaining a favorable business climate, and maintaining a sound financial structure.

## ***1. Pension System***

Restoring the integrity of the City's retirement system has arisen as a top priority for the long-term fiscal health and stability of San Diego. Reaching that goal is a major driver of the MYFF, which includes full funding of all requirements and the application of any savings towards addressing this challenge.

## ***2. Reserves***

The City maintains several reserves for its operations. These include reserves for the General Fund, as well as reserves for various Debt Service and Tax Funds, Special Revenue Funds, Enterprise Funds, Capital Improvement Funds, and Internal Service Funds that can only be used for their intended purpose. Reserves supporting General Fund operations include the Allocated Reserve, used to carry forward current year funds for projects that could not be completed prior to the end of the fiscal year, and the "Unappropriated" or General Reserve, established to fund major General Fund emergencies.

Recognizing the importance of maintaining adequate reserves to address unforeseen contingencies such as natural disasters, catastrophic occurrences or excessive liabilities or judgments, the City Council adopted a policy in October 2002 providing for the establishment of a General Fund Reserve at a minimum of 3% of annual General Fund revenues. The policy

further defines a goal of a 5% reserve, to be achieved by 2014. To ensure progress toward this goal, the Council Policy provides that when General Fund revenues increase by at least 2%, there be a corresponding increase in the General Fund Reserve equal to at least 10% of any General Fund revenue increase in excess of 2%. This provision related to the increase in General Fund revenue was suspended for the FY 2005 budget.

The MYFF assumes that the City will appropriate General Fund revenues to meet the 5% goal. Schedule VIII of the MYFF Model tracks the City's progress in this regard (as part of its analysis of various financial ratios). This schedule also calculates all of the City's general-purpose reserves as a percentage of general-purpose revenues. This latter calculation adds the TOT, Environmental Growth, Police Decentralization and Fire and Lifeguard Facilities funds as part of the analysis. Combined fund balance in these special funds (not including the General Fund Unappropriated Reserve) is projected to remain constant at \$21.7 million.

For FY 2006, the General Fund Unappropriated Reserve is \$36.6 million, or 4.3% of General Fund revenues and assumes to reach 5% of General Fund revenue by FY 2009. The total general purpose reserve for FY 2006, which includes the selected Special Revenue Funds, is \$58.3 million, or 6.0% of general purpose revenues.

### ***3. Special Funding Ordinances***

The City has adopted various policies regarding the use of certain revenues that otherwise would be discretionary General Fund revenues. Due to General Fund revenue constraints, the City Council waived the application of all three of these policies as part of the FY 2005 budget. The MYFF assumes that these ordinances continue to be waived in FY 2006, but that full funding according to their terms will be instituted beginning FY 2007.

The special funding policies are discussed below:

- The Mission Bay Ordinance requires that one-half of all revenue from Mission Bay rents and concessions in excess of \$20 million be allocated to the Mission Bay Improvement Fund and the Regional Park Improvement Fund. The Mission Bay Improvement Fund is to be used only for permanent public capital improvements and deferred maintenance of existing facilities in Mission Bay pursuant to the Mission Bay Park Master Plan. The Regional Park Improvement Fund is to be used only for permanent public capital improvements, planning, deferred maintenance, and for land acquisition for San Diego Regional Parks.
- The Council's Community Parking District Policy allocates 45% of parking meter revenues to local parking meter districts. In FY 2004, the City increased its parking meter rates, and suspended the sharing of the increased revenues with the parking meter districts.
- The Council's policy for the Annual Appropriation for Library Operation and Maintenance directed the City Manager to provide an operating budget proposal for the Library Department equal to four and one-half percent of the City's General Fund, increasing by one-half percent each year until an amount equal to six percent of the

General Fund is reached by FY 2005. While the MYFF assumes that this policy is restored beginning in FY 2007, funding will require shifting resources from other City departments.

#### ***4. Debt Management***

The City issues long-term debt from time to time to finance large capital projects, such as public buildings, parks, infrastructure and open space acquisition, when paying for these projects out of current revenues would be impractical. The City uses a variety of financing methods, including general obligation bonds and lease obligations for general-purpose projects, and revenue bonds and revenue certificates for its enterprise utilities. Since general obligation bonds require two-thirds voter approval, their use has been limited. Two measures have been approved by voters, for open space acquisition and development (1978) and for an emergency communications system (1991). As of June 30, 2005, the City will have \$14.5 million in general obligation bonds outstanding (after the redemption of most of the Open Space General Obligation Bonds).

The balance of the City's financing for general purposes (as opposed to water, wastewater and other special purposes) has been accomplished through lease revenue bonds and certificates of participation. These financing vehicles are typically not voter-approved and are not considered "debt" under the State Constitution. Lease payments are made from annual appropriations of general-purpose revenues. As of June 30, 2005, \$516.5 million in various lease obligations will be outstanding.

In analyzing a city's debt position, most municipal credit analysts combine lease revenue obligations and general obligations to create what is commonly called "tax-backed" or "direct" debt. This analysis excludes enterprise revenue bonds and other obligations supported by limited revenue pledges. Sometimes, debt analysis will combine the tax-backed debt of an entity with that of its overlapping jurisdictions (for example, the City's overlapping debt would include obligations of San Diego County and the San Diego Unified School District). This total of overlapping obligations is referred to as "overall debt". Given the limitations of property taxation in California, most credit analysis focuses on the direct obligations of the issuer itself, which is referred to as "net direct debt".

It is the City's goal to maintain a manageable level of debt, using data provided by the rating agencies to assess how it compares to its peers. The three ratios considered most important in this regard are:

- Net direct debt per capita.
- Net direct debt as a percentage of assessed valuation.
- Annual General Fund debt service (i.e., payment on lease revenue bonds) as a percentage of available revenue (often referred to as "lease burden").

As of June 30, 2005, outstanding net direct debt will total \$531 million. The following compares the City's debt ratios for 2005 with the medians for other California cities, as reported by Moody's Investors Service (the most recent statewide data is as of June 30, 2003). The City uses



various Special Revenue Funds to budget for the debt service on its outstanding General Fund backed lease obligations. Therefore, in analyzing debt service as a percent of revenues, these other funds must be aggregated with the General Fund.

<b>Comparative Debt Ratios</b>			
Ratio	San Diego	All California Cities	Ten Largest California Cities <sup>1</sup>
Direct Debt Per Capita	\$406	\$299	\$691
Direct Debt as % of Assessed Value	0.42%	.3%	1.0%
Net Lease Burden (% of Revenues)	4.01%	2.9%	4.7%

<sup>1</sup>Excludes the City and County of San Francisco and the City of San Diego

The fact that the City is above the statewide median is not a surprise. The City has undertaken several major financings in support of its tourism industry, which is common for large cities. In fact, San Diego is below the median for other large cities in the State.

The City's debt burden is also relatively moderate when compared to large cities nationwide. For national comparison, one has to look at "overall" debt, which includes the direct debt of overlapping jurisdictions such as counties and school districts. This form of analysis is required because the basic functions of cities vary from state to state. But in comparing San Diego to the median ratios for New York, Chicago, Houston, Philadelphia, Phoenix, Dallas, San Antonio and Detroit, San Diego is low relative to assessed value (2.7% as compared to 6.5% for the national big city median) and just below average relative to overall debt per capita (\$2,408, as compared to \$2,918 for the national median).

Two additional General Fund-secured lease obligations are currently planned: the second phase of the Fire & Life Safety Improvements lease revenue bonds (approximately \$41 million) and bonds for Library System Improvements (approximately \$191 million, to be issued in three series through 2010). Additional debt service from these future issues is estimated to peak in 2011 (beyond the MYFF forecast period) at about \$17 million a year. The proposed issue of pension obligation bonds would also be a General Fund obligation, although a portion of the debt service would be paid out of enterprise revenue funds. Rating agencies typically review a local agency's debt position both with and without its pension obligation bonds in evaluating its credit, since most jurisdictions have some form of pension liability even if it has not been bonded. The City also plans to issue bonds to finance wastewater capital improvements, and will refund existing bonds to lower interest costs whenever market opportunities present themselves.

## ***5. Unfunded Needs***

Over the years, the City has undertaken several exercises to account for needs for which no funding has yet been identified. This total inventory is daunting. While the MYFF does not attempt to solve this funding challenge, it is important that policy makers do not lose sight that demand on City resources extend beyond the annual operating budget. These unfunded needs are summarized below:

- **Public Safety Communications Project.** Approximately \$133 million is needed to replace key components of the communication systems used by the Police and Fire-Rescue Departments. Immediate funding of \$15 million is required, although no funding source has yet been identified.
- **The Unfunded Needs Report dated August 30, 2004.** This report identified \$627 million in needs of the City's operating departments that were considered necessary in order to fulfill department missions, meet mandates, or simply provide optimum service levels to the City's residents and visitors, but were not currently funded and could require general funding. These included needs of the Police Department (\$87 million), the Fire-Rescue Department (\$38 million) and the other departments of the City (\$502 million, which excludes \$30 million in needs identified by the Water Department for which enterprise revenues could be available). This assessment did not include capital needs.
- **Strategic Framework (\$2.5 billion).** The City has calculated the existing deficiencies in meeting current General Plan standards for the 24 urbanized communities being considered for the proposed "City of Villages" strategy. This strategy was designed to address projected population growth as part of the City's General Plan.
- **Other Unfunded Needs.** In addition to the above, for which an estimate of costs was readily available, other capital needs for which funding hasn't been identified include deferred maintenance, storm water pollution mitigation, and underground storage tank removal.

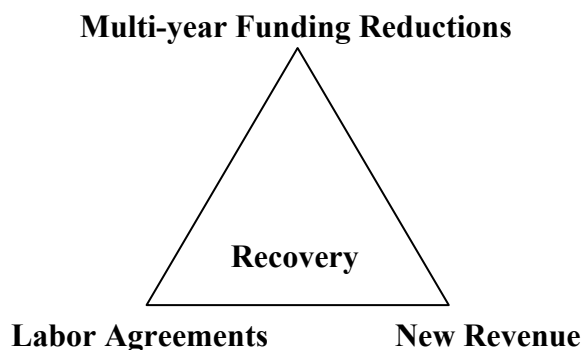
As part of this project, another inventory of needs was collected from City departments. Some of these items can be expected to overlap with unfunded needs identified in prior inventories. These additional potential department expenditures are significant, averaging \$89 million in new spending that could be added to the budget in each of the next five years.

## VI. RECOVERY PROGRAM

The results of the Multi-Year Financial Forecast underscore the necessity of implementing the City of San Diego's recovery package. Difficult policy decisions made in FY 2005 and proposed for FY 2006 are realized as early as FY 2007 and provide the foundation for an historic overhaul of how the City will operate in the future. Policy makers, employees and citizens, all necessary partners in the recovery program, are able to readily view positive or negative impacts on future years based on decisions made today.

The figures reflected in the Multi-Year Financial Forecast clearly indicate that without immediate reductions in the cost of doing business, the City will continue to struggle financially. This could include further service reductions, canceled programs, and closed facilities. However, by combining the elements of the recovery program—immediate and permanent multi-year funding reductions, conservative labor agreements, and new on-going revenue enhancements—the forecast for a more solid future could become more of a reality.

Just as the strength of the triangle has been used to identify the City's priorities, it can also be used to demonstrate the strength of a recovery program. Each component of the recovery program stands alone, yet the strength of the three combined elements provides the structural integrity that is the hallmark of the geometric triangle.



Focusing on just one area could help in the short term but will not establish the foundation that is required to strengthen the City's financial situation in future years. While each of the recovery program components does not have equal levels of impact on the City's fiscal solution, it is essential that the entire combination of solutions be included in the City's recovery program.

The three primary components for consideration by the Mayor and City Council are described below. Elements of these solutions are included in the Multi-Year Financial Forecast.

### ***1. Multi-Year Funding Reductions***

The process of developing the City of San Diego's Annual Budgets has been a challenging endeavor over the past several fiscal years. The requirements of providing services to the citizens of San Diego have increased while revenues have not increased at a corresponding rate. Budgeting is a revenue driven process in California; local government has minimal discretion to raise revenues and therefore must balance its budget through expenditure control. Service Level Reductions, specifically personnel reductions, are a very effective tool to reduce expenses. They can be expected to be incorporated in the FY 2006 Proposed Budget. The continued use of funding reductions as the primary means of balancing General Fund budgets, however, will have long-term impacts on the City's ability to meet the needs of its citizens as the demands for services continue to increase.

The following chart identifies the funding reductions taken by General Fund departments over the past three years and the proposed reductions required for FY 2006.

<b>Fiscal Year</b>	<b>FTE Reduced</b>	<b>Expenditure Reduced</b>
2003	(34.20)	(\$10.3) Million
2004	(143.66)	(\$28.4) Million
2005	(124.57)	(\$20.2) Million
2006 (Estimated)	TBD	(\$25.4) Million
Total	(302.43)++	(\$84.3) Million

As indicated by the chart, almost \$84 million in funding reductions have been or are proposed to be taken to City operations. This figure is slightly more than the entire FY 2005 budget for the Parks and Recreation Department, and yet even with these reductions, the City still has struggled to meet the funding requirements to maintain services.

As the non-public safety department budgets are reduced through expenditure funding reductions, their overall percentage of the General Fund total also declines. Each year, the Public Safety departments gain a larger percentage of the scarce fiscal resources available and thus increase their overall percentage of the General Fund.

Due to this continued Public Safety funding priority, the net effect of expenditure funding reductions will continue to adversely impact non-public safety departments to the point that the City may only be able to provide Public Safety services to the citizens. This observation should not be interpreted as a recommendation to lower the priority of funding Public Safety; however, it emphasizes that expenditure funding reductions by themselves cannot continue to be the primary solution to budget deficits. These reductions must be combined with the other components of the recovery program to be effective.

## ***2. Labor Agreements***

The City of San Diego is currently in labor negotiations with all four of the labor unions. In February, the Mayor and City Council presented a number of proposals to be discussed during labor negotiations. The proposals included:

- Institute a two-year salary freeze for all City employees for FY 2006 and FY 2007;
- Adopt a two-year freeze in any benefit increases for all City employees FY 2006 and FY 2007;
- Either increase the employee's contribution to the retirement system or reduce salaries an equivalent amount of 3.2%;
- Reduce pension benefits for new employees by excluding new employees from joining the pension system for the first three years of employment; or implementing other recommendations of the Pension Reform Committee, including eliminating the DROP program;
- Reduce retiree medical benefits by capping the contribution to retiree medical benefits for current employees at the current level and reducing or eliminating retiree medical benefits for new employees; and
- Implement a mandatory five-day work furlough for all City employees.

The MYFF Base Case includes instituting a salary reduction and one-year salary freeze for all City employees and a two-year freeze on benefit increases. Inclusion of these proposals in the MYFF is intended to give City policy makers an example of the long-term financial impact on the General Fund if these types of proposals were implemented.

### ***3. New Revenue***

The California Constitution requires that general-purpose taxes be passed by a simple majority of voters, while a special tax (i.e., a tax that is earmarked for specific purposes) must be passed by a two-thirds majority. Proposition E, a City Charter amendment passed in March 2002, attempted to apply the two-thirds majority requirement to general-purpose taxes. On July 1, 2004, a California State Appellate Court ruled that Proposition E was invalid because it attempted to modify State law.

New revenue sources have the ability to create significant revenue growth for the City of San Diego. Nevertheless, obtaining the requisite voter approval will be a significant challenge. The voters recently rejected two measures designed to increase the City's TOT in March and November 2004.

Below is a brief summary of potential revenue options that have currently been researched by City staff. Except where noted, these revenue sources would require a vote of the public in order to be implemented or increased. Any tax or tax increase that is levied for general purposes will require simple majority voter approval, while a new tax or tax increase that is levied for specific purposes will require a two-thirds majority approval. Because of the voter approval requirement, most of these options could not be implemented in time to help in balancing the FY 2006 budget.

- The City's current Business License Tax is a \$34 flat fee for businesses with 12 or fewer employees, and a \$125 flat fee plus \$5 per employee for businesses with 13 or more employees. Based on FY 2002 actual figures, doubling the current rates would generate an additional \$5.3 million in revenue and still allow the City to remain competitive with other California cities of comparable size.
- The Refuse Hauler Franchise Fee was increased by \$1 per ton in FY 2004; if it were increased by an additional \$1 per ton, it would generate an additional \$850,000 per year for the General Fund. This fee is paid by private waste haulers that conduct commercial business (including apartments and condos) within the City. This fee may be adjusted with City Council approval.
- The City currently does not levy a parking tax. This tax is similar to a franchise fee that is charged to private operators of parking lots within City limits. This tax is used by other cities throughout California. If the City were to implement a 10 % parking tax, it would generate approximately \$19.6 million in additional General Fund revenue.
- The current Property Transfer Tax is collected by the County of San Diego (at a rate of \$1.10 per \$1,000 of the sales price of real property). Of this amount, \$0.55 is allocated to the City. This type of tax collection is called "conforming". If the City levies a "non-conforming" tax at a rate above \$0.55 per \$1,000, the County would receive the full share of the \$1.10 per \$1,000, and the City receives the amount generated from its own tax rate. If the City levies its own "non-conforming" tax rate at \$1.75 per \$1,000, additional revenue to the General Fund would be approximately \$15.3 million per year.

- The City does not charge a refuse collection fee for municipal refuse collection services. The Environmental Services Department has estimated that a monthly refuse collection fee of \$10-\$13 would generate approximately \$39-\$45 million per year, covering the cost of residential refuse collection. A change to the City Charter to allow for the charging of this fee would require a simple majority vote by the public.

None of the revenue options discussed above, if implemented, will by themselves solve the City's challenges; however, they will provide increased opportunities for meeting the numerous expectations and requirements for City operations when combined with the two other elements of the recovery program.

## **VII. GOING FORWARD**

This Multi-Year Financial Forecast is a tool to help produce a comprehensive, long-range analysis of its General Fund revenues and expenditures. It is only a first step in what should be a regular exercise. The model can be used to help analyze major decisions as they are being considered, and should be updated to assist with the City's annual budget process.

This long-term forecast has revealed serious structural challenges to the City. While the outlines of a recovery plan are suggested, the specifics will require deliberation of and feedback from elected officials, staff, labor representatives, and the public. As alternative approaches to the City's challenges are identified, they should be incorporated into subsequent versions of the MYFF Model in order to forecast their long-term impact. This project is intended to be an ongoing planning tool and not a static report at one point in time.

There will be a number of opportunities to improve this planning tool as future generations of the MYFF are developed. As the Mayor and City Council, management and City staff uses the MYFF, they will evolve it to better meet their needs, giving further input and direction as to what assumptions and alternatives should be explored. Some of the existing schedules, such as those that track financial indicators, will be expanded to provide more robust analysis and comparisons. New schedules will be added to provide additional information and analytic results. More alternative scenarios will be developed to further explore the various opportunities available to the City to meet the needs of its citizenry within available resources. Tools such as this are truly valuable only if they are maintained and evolved to meet the particular needs of decision makers over time.